REGULATION NO. 12 OF THE MILK INDUSTRY TO ESTABLISH THE PRICES OF MILK AT ALL LEVELS

SECTION 1. Short Title:

This regulation shall be known and may be cited as Regulation No. 12 of the Milk Industry.

SECTION 2. Grounds and Authority:

Public Law No. 34 of June 11, 1957, as amended (5 LPRA §1092, et seq.), grants the undersigned Administrator the power to investigate and regulate all phases of the milk industry and its byproducts, including the production, processing, sterilization, manufacture, storage, purchase and sale, transportation and distribution of the main product and its byproducts. (See Article 5, paragraph (a), of Public Law No. 34, *supra*, 5 LPRA §1096a).

Article 6 (b) and (c) of the abovementioned Act specifies the scope of the economic regulations and the general method that shall be used by the Milk Industry Regulation Office (ORIL, its Spanish acronym).

In the exercise of such regulatory powers, this administrative agency approves and promulgates orders determining the price of the milk produced by the cattle farmers who are licensed by the agency, the prices that the processors pay and, subsequently, **the prices at which wholesalers, agents, retailers**, and consumers acquire the milk. To do this, our enabling Act requires a review, at least once a year, of the conditions of the supply and demand in the industry, including the costs of production, processing, distribution and sale of milk, to determine its prices at the various levels of the distribution channels, from the farm to the retailer.

SECTION 3. Purpose:

This regulation is based on the regulatory principles included in Public Law No. 34, *supra*, which are adopted herein in compliance with the abovementioned judicial order.

This administrative agency held multiple public hearings with the purpose of receiving proposals related to the state of the milk industry in Puerto Rico and the additional regulation deemed necessary to determine a price of milk that would include a reasonable profit for the components of the industry.

Representatives of the producers, processors, agents, wholesalers, retailers and other interested parties participated at the public hearings and presented their recommendations verbally. They also submitted documents and data during the hearings and the days that followed. The presentations and data provided by the participants were analyzed at this administrative agency, by subject matter experts that we contracted and by our personnel, in order to draft and promulgate these price regulations in compliance with the abovementioned judicial order.

SECTION 4. Definitions:

1. Secretary - Secretary of the Department of Agriculture.

2. Administrator - Administrator of the Milk Industry Regulation Office.

3. Administrative Agency - refers to the Milk Industry Regulation Office.

4. Dairy farm - means the place where one or more healthy cows are kept and milked and where this milk is sold or offered for sale to a processor for human consumption.

5. Processors - means the persons who are owners, administrators or managers of businesses engaged in the pasteurization or ultra-pasteurization and homogenization of fluid milk.

6. Raw milk - is the whole milk secretion, excluding the colostrum, which is obtained by milking one or more healthy cows, which has not yet been subjected to any processes.

7. Fluid milk - refers to the raw milk that the processing plants receive and retain for its homogenization and pasteurization or ultra-pasteurization and homogenization processing or aseptic processing. Examples of fluid milk are fresh milk and UHT milk. The fluid milk products to be included are those listed by the Code of Federal Regulations, 7 CFR 1000.15 – Fluid Milk Products.

8. Fresh milk - means raw milk produced at the dairy farms, that is later pasteurized and homogenized by the processors and is classified within the fluid milk category. Fresh milk may be processed with different proportions of fat and mixed or unmixed with other ingredients.

9. UHT Milk - means the raw milk produced at the dairy farms, which is submitted to a process of ultra-pasteurization by the processors and is

classified as one kind of fluid milk. UHT milk can be processed with different proportions of fat and mixed or unmixed with other ingredients.

10. Milk - this generic term refers to raw milk retained and processed by milk processing plants, which is converted to any type of fluid milk for sale to consumers, with or without the addition of ingredients or flavors.

11. Act - refers to Act No. 34 of June 11, 1957, as amended.

12. Pasteurization - process through which each particle of the milk or dairy product is heated to specific temperatures, which are constantly maintained for the corresponding length of time in equipment that is appropriately designed, installed and operated for such purpose.

13. Milk producer - person who operates a dairy farm and sells or offers for sale raw milk to pasteurization or processing plants or centers.

14. Milk processing plant - establishment where milk is received, processed, pasteurized, ultra-pasteurized, processed aseptically and/or refrigerated, as applicable, for its distribution and sale.

15. Fresh Milk Business - is the business of the processors that comprises all activities related to the processing of raw milk, which generates the revenues that are derived from fresh milk processing and sales.

16. UHT Milk Business - is the business of the processors that comprises all activities related to the processing of raw milk, which generates the revenues that are derived from UHT milk processing and sales.

17. Ultra-pasteurization - process through which milk is heated to 280E Fahrenheit, or to a higher temperature, for at least 2 seconds before or after packing it.

18. Aseptically processed milk and dairy products - milk or dairy products that have been submitted to sufficient thermal treatment and packed in hermetically sealed containers under the requirements of the Code of Federal Regulations, Title 21, in order to render the product free of viable microorganisms, including spores, capable of reproducing under non-refrigerated conditions of storage.

19. Agent - means the natural or juridical person authorized by ORIL to engage in selling fresh milk or ultra-pasteurized milk from a processor in

the municipalities of Puerto Rico, for which said person has entered into a contract with the processor in question. Provided that the agent shall not be an employee of the processor and that the milk delivered to it by the processor must be sold by said person to retailers and consumers.

20. Wholesalers - means a natural person or legal entity that operates a business establishment who sell fresh and/or UHT milk to retailers and consumers.

21. Retailers - means a natural person or legal entity that operates a retail business establishment who sell fresh and/or UHT milk to consumers.

22. Surplus - part of the raw milk production that is not retained by the processing plants to process fresh milk.

23. Docket 2289 – Amended Opinion and Order NUNC PRO TUNC of the United States District Court for the District of Puerto Rico, Civil No. 04-1840 (DRD).

SECTION 5. Adoption of Regulatory Principles:

The regulatory principles and parameters that shall govern in the determination of the price of milk are hereby adopted in these regulations.

These regulatory principles and parameters start from the basic premise that all price regulations must be fair and reasonable. In this sense, participants in a regulated market have the right to recover their costs and obtain reasonable profits that justify their investment. The costs that are recognized in a regulated market must comply with certain characteristics, which are summarized below:

A) The costs must be prudent, which implies that they must be reasonable and incurred in good faith.

B) The costs must also comply with the used and useful regulatory principle. That is, they must be indispensable and useful in the corresponding productive process.

C) The recognized costs must also comply with the characteristic of being known and measurable, which implies that, for them to be recognized by the regulations, such costs or expenses must be completely legitimate insofar as they are genuine, necessary and typical of the productive activity. Furthermore, they must be quantifiable and measurable with

reasonable ease.

SECTION 6. Designation of Regulatory Accounts and Procedures to Measure the Recoverable Costs and the Reasonable Rate of Return:

A) **Producers**

We hereby recognize as expense accounts of the producers for regulatory purposes some of the accounts itemized in the 2007 update of the Comprehensive Economic Study conducted by the Agricultural Statistics Office of the Department of Agriculture.

The following are the expenses recognized in these regulations as regards the operation of the producers:

1. Concentrated Feed: Refers to the cost or price paid by cattle farmers for the feed produced by the grain mills to feed dairy cattle. Its use is indispensable to attain an appropriate and competitive milk production.

2. Other Feed: This expense refers to the cost of other nutrients used by cattle farmers to feed their herd, such as honeys and their byproducts, fodder and other related products.

3. Salaries and Wages: Refer to the remuneration paid by cattle farmers to the employees at their dairies and farms related to the work they carry out to produce milk at same. If other work that is not directly related to the production of milk is carried out at the farm, the portion of the salaries corresponding to those other activities shall be deducted from the total of that expense.

4. Fringe Benefits: Refer to additional remunerations granted by milk producers to their employees, in addition to salary, such as contributions to a private medical insurance plan or other similar benefits, such as social security, unemployment, State Insurance Fund Corporation benefits, disability insurance, Christmas bonus, vacation leave and others.

5. Leases: Refer to the cost incurred to secure the possession of real or personal property that is necessary, convenient and reasonable. Its use must be related directly to the operation of milk production, and this expense shall be adjusted if that real or personal property is used for other activities that are not related to the production of milk.

6. Use of Land: Compensation recognized as an expense for the use of their own land, estimated using the lease value of such land for agricultural uses.

7. Taxes: The taxes that milk producers have to pay to the state due to the imposition of tax acts are recognized as an expense.

8. Operation of Agricultural Vehicles and Machinery: This expense category refers to the costs that milk producers incur for the operation of the agricultural vehicles and machinery that they use for their milk production operation, including the expenses related to their repair and maintenance. Gasoline and diesel fuel expenses are excluded from this category.

9. Gasoline and Diesel Fuel: Refer to the costs incurred by milk producers in gasoline and diesel fuel for the operation of their vehicles and machinery used in their milk production operation.

10. Electric Power: The cost of the electric power supply in the dairy is recognized as an expense, as billed by the Electric Power Authority.

11. Water: Refers to the cost of water consumption for the milk production operation.

12. Telephone: Refers to the cost of telephone use for the milk production operation.

13. Fertilizer: The cost of the use of fertilizers for the farming and maintenance of the pastures of the producers' farms.

14. Depreciation: The quantification of the deterioration in the loss of the value and the useful life of the buildings, motor vehicles, equipment and machinery of milk producers is recognized as a regulatory account or expense.

15. Medications: Refer to the cost of the veterinary products that milk producers acquire to cure and rehabilitate their herd.

16. Repairs and Maintenance: Refer to the cost incurred in the repairs and maintenance of the buildings, equipment of the dairy and other equipment and assets that are used in the producers' farms in relation to milk production.

17. Cleaning Supplies: Refer to the cost of the products and supplies that producers acquire to maintain the appropriate hygienic conditions in their dairies, as required by the regulations of this administrative agency.

18. Insurance Policies: The total insurance premiums paid by producers to insure themselves against specific risks inherent in their productive activity is considered an expense or cost, providing that this administrative agency shall only recognize the total premiums for insurance policies that are equivalent to the real value of the assets.

19. Transportation of Milk: Refers to the sums paid by cattle farmers to the processing plant to which they deliver their raw milk production for its transportation from their dairy to that plant. The total of this charge is determined by this administrative agency and is likewise deducted by the fresh milk processing plants from the sum they pay to producers for the milk picked up from them.

20. Use of Cattle: Refers to the cost or expenses incurred by producers to continuously replace their herd, in particular the milking cows, to maintain a stable production throughout the year. Dairy cattle have a limited useful life and their physiological characteristics require their constant rotation to maintain appropriate levels of production.

21. Professional Services: Expenses incurred by milk producers when contracting the services of professionals who provide specialized services that cannot be performed by other regular employees, such as veterinarians, nutritionists, accountants, attorneys, etc. These expenses must be necessary and indispensable and must also be directly related to the milk production efforts.

22. Unpaid Labor: Work performed in the operation of the dairy farms by the owners and/or their relatives or partners that is not included in the payroll.

23. Miscellaneous Expenses: Refer to minor expenses incurred by milk producers that cannot be adjudicated to the previous expense categories. As long as they are useful, necessary, reasonable and real, they are recognized as such.

24. Profit Margin of Producers Based on their Equity capital:

a) The rate of return for operating capital that has not been financed is calculated by taking the book value of the buildings (adjusted at 50% to recognized past government programs that paid for such buildings), the machinery, the trucks and the equipment, and subtracting the balance of the loans due in less than one year and the non-mortgage loans due in more than one year. In order to obtain the return per dollar of the equity capital, the previously adjusted total is multiplied by the rate of return that will be calculated as recommended by the American Agricultural Economic Association, specifically the Task Force on Commodities, Costs and Returns.

b) The calculation is based on the Fisher equation adjusted for risks as developed on pages 2-4 of the AAEA Commodity Costs and Returns Estimation Handbook, hereinafter "the Handbook." The equation is the following:

Required Return Producers =
(1 + real interest rate + risk factor) X (1 + inflation rate)

In this case, it is assumed that the real interest rate is 2% (consistent with the long term scope listed in the Handbook on page 2-39), an estimated inflation rate and an average risk factor for agriculture of 3% from the rates recommended in the Handbook (see pages 2-36 and 2-39).

B) **Fluid Milk Processing Plants**

We hereby recognize the following accounts corresponding to the **Fluid Milk Business,** which are listed and explained below: B.1 Income Accounts; B.2 Expense Accounts; B.3 Asset Accounts; B.4 Liability Accounts; B.5 Net Worth Accounts.

We must clarify that the fluid milk processing plants might process other products that are not related to fluid milk. To do this, they might use the same facilities and resources they use to process fluid milk. Therefore, regulatory accounts that are listed and determined below refer solely and exclusively to the phase of fluid milk processing, which requires the effective segregation of such accounts from those incurred in the processing of products other than fluid milk.

While the expense accounts comprise a comprehensive list of all expenses incurred in the processing of fluid milk, not all expenses in this list are included as a recognized expense in the regulated margin of the milk processing plant.

If, in the future, a processor participates simultaneously in both businesses, that is, in the fresh milk business and in the UHT milk business, it shall keep the accounts of those two businesses separate.

The separation of the specific accounts corresponding to the fresh milk business or the UHT milk business shall be made through the following procedure: First, such income, expenses, assets and liabilities as may be directly identified and allocated to the fresh milk business or to the UHT milk business shall be included. Second, income, expenses, assets and liabilities that are common to the fresh milk and UHT milk businesses, and to other businesses (e.g., juices) are allocated to each line of business. The general principle is to allocate variable income and expenses according to sales volumes (quarts) or production volumes (quarts). Production expenses shall be allocated in accordance with production volumes; while sales, distribution and marketing expenses, together with general and administrative expenses, shall be allocated according to sales volumes. General and administrative expenses, and other such expenses as are common to the other businesses of affiliated companies, shall be allocated according to the dollar value of sales. Asset and liability accounts that are not directly identifiable shall be allocated to the fresh milk business, the UHT milk business and other businesses, by using sales volumes or dollar sales, depending on the nature thereof. Finally, asset and liability accounts directly related to cost accounts shall be allocated by means of the same procedure used to allocate the cost accounts to which they are related. Once an allocation method is adopted to a certain account, such method could be later change or amended, for just cause, with the approval of ORIL's Administrator.

B.1 Income Accounts

The following shall be recognized as regulatory income accounts of fresh milk processors:

1. Gross Income from sales of fresh milk and/or UHT milk made to agents, wholesalers, retailers, or directly to consumers:

   a. Agents
   b. Wholesalers
   c. Retailers
   d. Consumers

2. Less - Milk regulation deductions:

   a. Auditing and administrative expenses

b. Regulatory Accrual

3. Gross income from sales of fresh and/or UHT milk, after milk regulation deductions.

4. Income from payments made by the FFIL [Spanish acronym for the Milk Industry Development Fund] for the processing, packaging and delivery of fresh milk supplied to the School Lunch Program.

5. Less - Milk regulation deductions of income payments made by the FFIL:

a. Auditing and administrative expenses
b. Regulatory accrual

6. Income from payments made by the FFIL to processing plants, after milk regulation deductions.

B.2 Expense Accounts

The following shall be recognized as regulatory expense accounts of fresh milk processors:

1. Raw Milk: This cost item includes the amount paid for the raw milk retained by processors, with the exception of the raw milk use for the processing of milk for the School Lunch Program, which is paid by processors to the producers and thereafter reimbursed to the processors by the FFIL.

2. Ingredients: This cost item includes the ingredients used in the processing of fluid milk. For purposes of this Regulation, only vitamins A and D will be considered ingredients, and for the quantities that comply with the specified limits in the Code of Federal Rules (CFR), and any other ingredient that is required by a product with prices regulated by ORIL. Also the cost of ingredients required in fluid milk supplied to the school milk program not covered by the Fondo para el Fomento de la Industria Lechera (FFIL) to the processing plants will be included in this account.

3. Containers (Carton and Pouches, Plastics and Crates): Refer to the cost of acquiring the containers used by the processing plants for pasteurized milk, including the cost of replacing the crates that are used to transport fresh milk. Fluid milk processors have the discretion to identify the best methods to obtain the products necessary for bottling and packaging. The costs of plastic lids and

containers acquired by processors from parent companies, subsidiaries or affiliates shall not exceed the amount of such costs as they would have to incur were they to purchase those plastic caps and containers from independent companies. The costs of those plastic lids and containers shall include shipping fees, insurance, commissions and such other miscellaneous expenses as must be paid to independent companies that can provide products of the same quality and on similar supply terms, both in Puerto Rico and in the United States and abroad. To do this, the processors must provide evidence of comparative evaluation with prices for similar products, where the quantity of containers considered for price quotations should be consistent with the scale of purchases by the milk processors. Docket 2289 at page 96 "clarifies that there must be a 'fit' relating to the size of the companies, the volume of sales and a container that is proper relating to the geographic area of the warm temperature of Puerto Rico."

4. Salary and Wages: Refer to the remuneration that processors pay to their employees solely and specifically in relation to the duties they perform in the processing of fluid milk. If these employees carry out other work related to the processing of products other than milk, the portion of the salary and wages corresponding to those other activities shall be deducted from the total of that expense.

5. Payroll taxes: Refers to those payments or contributions that must be made by the processing plant with respect to the salaries and wages that it pays its employees as provided by law, such as Social Security, unemployment insurance, etc. These payroll taxes will be adjusted proportionally to the percentage of time invested by the employees in the production of products other than milk.

6. Fringe Benefits: Refer to additional remunerations granted by processing plants to their employees, in addition to salary, such as contributions to a private medical insurance plan, life insurance, vacation leaves or other similar benefits. This expense will be adjusted to deduct the time the employees invest in processing products other than milk.

7. Fuels: Refers to the cost of such fuels as are used to operate the machinery and equipment that consume it in the fluid milk processing operation.

8. Gasoline and Diesel Fuel: Refer to the cost of the gasoline and diesel fuel used for the operation of the motor vehicles of milk processing plants. This cost shall be allotted according to the volume of milk sales, excluding agent sales.

9. Tires and Tubes: Refer to the costs associated with the tires and tubes of the

vehicles used for the transportation of pasteurized milk. These costs shall be distributed according to the sales volume, excluding agent sales.

10. Machinery and Equipment: Refer to the expenses in the lease of machinery and equipment, depreciation and the repair and maintenance of the machinery and equipment used to process milk.

11. Electric Power: Refers to the expense incurred by processing plants in electric power, as billed by the Electric Power Authority, and renewable energy production costs.

12. Water: Refers to the portion of the cost of water consumption supplied by the Aqueduct and Sewer Authority to processing plants that is directly related to the processing of milk.

13. Supplies (for Cleaning, Laboratory and Offices): Refer to the supplies used for cleaning the industrial plant, the laboratory and the offices of the processing plant.

14. Vehicle Expenses (Including Depreciation, Repair and Maintenance): Refer to the expense incurred by processing plants to maintain their fleet of vehicles used in the fresh milk processing operation and the distribution of the end product. It shall also include depreciation, rent expenses, expenses to obtain licenses and other expenses associated with the vehicles involved in the processing of fluid milk. This expense item must likewise be adjusted to exclude the expenses related to the transportation and distribution of products other than fluid milk.

15. Shrinkage and deterioration: Refers to the value of the milk that is lost in the normal process of pickup from dairy farms and in processing. An expense where the volume of shrinkage exceeds three percent of the volume of retained milk shall not be recognized. The percentage of shrinkage and deterioration shall be calculated based on a determination of the percentage represented by the number of quarts lost in the milk pickup, processing, and storage in plant, therefore unavailable for sale, with respect to the total number of quarts retained by processing plants in the period under analysis.

16. Excise Taxes and Municipal Licenses: Refer to the payments of contributions and duties imposed by law on processing plants, after adjusting and excluding the proportional part that must be adjudicated to the processing of other products.

17. Insurance Policies: Refer to the expense incurred in insurance premiums contracted by processing plants that fall within the margins of reasonability as

compared to similar companies. The corresponding adjustment must be made insofar as the insurance policies include assets, machinery or equipment that is also used to process other products. The expense in premiums that will be recognized shall be in keeping with the replacement cost of the insured asset.

18. Professional Fees and Contracted Services:

a. Ordinary expenses: Refer to the expense incurred by processing plants when they recruit and hire professionals or any technical or specialized personnel to render certain specialized services and for which there is no one equally capable and available among their managerial staff. Such expense must be necessary and indispensable, in addition to the fact that it must be directly related to the milk processing business, and not with the processing of other products.

b. Extraordinary expense: Docket 2289 states at page 95 that "the court ORDERS that non-recurring fees are to be accepted and amortized using a scientific, rational parameters [sic] used by regulators in markets similar to the Puerto Rico market. This Order depends on the practice being accepted under the general accepted accounting principles ("GAAP"). The Court places emphasis on the Tenoco requirement as to "fitness" with the Puerto Rico market. See 876 F.2d at 1024." Professional fees and contracted services that are of an extraordinary non-recurring nature shall be amortized within a term of five years from the month in which they are recorded in the account. The amortization will be done using the mortgage formula for a period of five years and using the same rate of return calculated in Section B.6.2.a below as interest.

19. Communications: Refer to the expense incurred for telephone services and other means of communication that are necessary and convenient for the pickup, processing and distribution of milk.

20. Building Expenses: Refer to the portion of the expenses, including rent and depreciation, incurred in the facilities of processing plants and their milk deposits that are related to the milk business.

21. Land Use: Compensation recognized as an expense for the use of one's own land, estimated by the lease value of such land for use in the milk processing operation that is related to the milk business.

22. Bad or Irrecoverable Debts: Refer to the loss produced by the lack of payment that may occur exclusively in the credit sales of processed milk. This expense

shall be recognized insofar as its magnitude falls within the reasonable parameters of similar companies and/or is based on the historical experience of the last five (5) years. In case the plants need to adjust their accounts receivables to reflect collection issues and the level of bad debt for a year might exceed the historical average, an independent accounting firm study must show that the adjustment is justified.

23. Financing Expenses: Refer to the expense or cost of the financing obtained by processing plants, whose usefulness is directly related to their industrial milk processing operation.

24. Expenses on Freezers Provided to Clients: Refer to costs incurred by processors for the freezers that they own and install in the business establishments of retailers, including depreciation, repairs and maintenance shall be recognized.

25. Marketing and Advertising: Refer to such expenses as are incurred by processing plants in efforts and activities aimed at marketing and advertising their products exclusively related to milk. Payments for exclusive rights of distribution shall not be recognized under this category, provided that ORIL enforces the prohibition against discounts in the case of retailers. Payments made by processors to retailers for shelf space or cooler space, shall be recognized if they are not associated with an exclusive rights of distribution agreement. The total costs per quart allocated to this account may not exceed point two percent (2%) of the average gross price per quart of milk sales from processors to retailers. This limit will be imposed as an overall cap and not on a per transaction basis.

26. Tolls: Refer to the expense incurred when traveling in certain expressways of the country, with toll plazas. This charge or expense must be adjusted according to the ratio of milk to other processed products that are transported on those expressways.

27. Returns of Damaged Products: Refer to the cost or loss of the plants due to the returns of damaged products. This expense is solely and exclusively limited to products related to milk delivered by processors to their clients, and its admissibility shall depend on the fact that its magnitude falls within the reasonable and recognized parameters of similar companies and/or is based on the historical experience of the last 5 years. In the case that force majeure events, such as an act or acts of God, increase the return of damaged products from retailers over the historical experience, the excess return of damage products shall be allowed.

28. Incentive for Prompt Payment: Refers to the sum that processors allow their

clients to deduct from the total sale of milk if it is paid within a specific brief period of time. The total expense from these incentives may not exceed 1% of the total sum of the sales accounts. This limit will be imposed as an overall cap and not on a per transaction basis.

29. Independent Sales Agents: This expense corresponds to the remuneration received by independent sales agents, including:

    a. Discounts granted to agents in prices of fluid milk sold to grocery stores, cafes, and/or retail business.

    b. Discounts granted to sales agents from income payments made by the FFIL to milk processors, for processing, packaging, and delivery of fresh milk to the Lunch School Program.

    c. Remuneration, **other than discounts**, received by independent sales agents from fresh milk processors for their work in the distribution and sale of fluid milk.

    Discounts to agents should cover their costs of operation plus a reasonable profit margin. ORIL's Price Orders shall establish the maximum discount per quart of fresh milk and/or UHT milk payable to sales agents by milk processors.

30. Miscellaneous Expenses: Refer to minor expenses incurred by processors that cannot be allocated to the previous expense categories, as long as they are useful, necessary, reasonable and real. This account or any other account shall not include penalties, fines, surcharges or interest imposed for lack of compliance with any agreements, laws or any other legal dispositions.

31. Amortization of Deferred Expenses: This account is reserved for capitalized and amortized expenses, as is the case of non-recurring expenses included in the professional fees and contracted services account. These expenses shall be amortized within a term of five years from the month in which they are recorded in the account.

32. Merchandisers: Refers to the expenses incurred by the plants in "the distribution of the milk to the supermarket food stores and the warehouse sales companies in Puerto Rico" (Docket 2289, p. 93). Docket 2289 states that "[merchandisers] is a valid expense that must be recognized in its totality...the merchandiser is part of the distribution chain, taking the milk from the processing plant to the stores where the consumers purchase the milk." Docket 2289 goes on to say:

"The law in Puerto Rico mandates that expenses relating to the distribution of the milk be evaluated every four years 'for the purpose of revising and keeping the price of fresh milk within a reasonable and equitable margin for the different sectors within the industry, that is, producers, processors, distributors of the product and consumers in general.' 5. L.P.R.A. §1107 (e). In the instant case, the milk processors act as both processors and distributors of their products, hence the merchandisers' costs constitute a cost of placing the product available to the consumers. Placing this key element of the distribution in the hands of the supermarkets and/or large discount department and warehouse stores is dangerous as the product needs to be timely shelves or else, be at risk of turning stale or ruined."

33. Exclusivities: Refer to payments, expenses, and other amounts related to arrangements with retailers to sell the milk processing plant products on an exclusive basis. These costs are not part of recognized regulatory expenses for the calculation of the regulated margin.

34. Transportation Cost Recovery: This cost recovery refers to the sums paid by cattle farmers to the processing plant to which they deliver their raw milk production for its transportation from their dairy to the plant. The amount per quart of milk of this charge is determined based on a transportation cost study that will be conducted and agreed upon unanimously by the members of ORIL's board for the determination of its level. The study should be updated on a yearly basis and the unit transportation cost will be determined in the same administrative process for the determination of the prices of fluid milk.

B.3. Asset Accounts

1. Cash in Hand and Cash in Banks: Cash in Hand and in Banks acts as a compensation account for all the cash (coins and bills or legally accepted equivalent, such as wire transfers) received during the ordinary course of business and which has not yet been deposited into a legally recognized financial institution, as well as all the cash deposited into bank accounts kept by the processors. Highly liquid assets, easily converted into cash without the risk of losses, will be considered equivalent to cash. Generally, cash equivalent has a maturity no higher than 90 days from its emission date. This account must also include any cash available, such as cash for minor expenses or petty cash and working capital. Cash in hand and banks that cannot directly be allocated to the fluid milk business must be allocated (each period) to these businesses by taking as a basis the dollar value of sales.

2. Accounts Receivable (Net): This account includes all sums owned by customers for sales of products and other Accounts Receivable arising from the normal course of business of fluid milk and payable within the current period. Allocation to the fresh milk business or UHT milk business shall be made for each period:

   a. Customers: Sums owed by customers must be allocated to the fresh milk business or UHT milk business, based on the dollar value of sales.

   b. School Lunch Program, INDULAC, FFIL, and the Price Stabilization Fund: The total amounts to be charged must be included in these accounts only if they correspond to the fresh milk business or UHT milk business.

   c. Employees and Salespersons: The amounts owed by employees and salespersons must be allocated to the fresh milk business or UHT milk business, on the basis of the dollar value of sales.

   d. Others: Any other amount to be charged must also be allocated to the fresh milk business or UHT milk business, pursuant to the dollar value of sales.

3. Inventories: Inventories are merchandise or supplies in hand or in transit at a given point in time. The inventory count must occur at year's end to guarantee that the physical amount equals the amount recorded on the books. Inventory valuation requires a determination of the cost allocated to the inventory for raw materials, work in progress, finished articles, and any other article of inventory. Inventories must be valued in accordance with GAAP [generally accepted accounting principles]. The Inventories account shall include solely the amounts corresponding to the fresh milk business or UHT milk business and shall consist of four sub-accounts:

   a. Ingredients - Raw Milk: This account shall include the inventory of all the raw milk and other ingredients used in the fresh milk business or UHT milk business.

   b. Finished Products: This account shall include the amount of inventory of the finished product associated solely with the fresh milk business or UHT milk business.

   c. Packaging Materials: This account shall include the amount of inventory of packaging materials associated with the fresh milk business or UHT milk

business.

d. Others, Gasoline, Oil & Diesel: This amount of inventory for other articles, gasoline, oil and diesel shall be allocated to the fresh milk business or UHT milk business (each period), based on sales volumes.

4. Prepaid Expenses: Prepaid expenses reflect disbursements that are paid within an accounting period, but are neither used nor fully consumed until the next accounting period.

5. Property, Plant and Equipment - Net: Property, plant and equipment are tangible assets that are utilized in the production or supply of goods and services or to rent to others, and it is expected that they are to be used in more than one period. The account shall include all fixed assets associated with the fresh milk business or UHT milk business. The amount corresponding to the fresh milk business or UHT milk business for assets used by two or more line of businesses shall be determined on the basis of sales volumes, and this amount shall be kept fixed over the course of time. It shall consist of the following sub-accounts:

a. Land: This account includes the cost of land for the use in the operations of milk processors.

b. Buildings: This account includes the cost of the buildings purchased or constructed for use in the milk processors' business as well as the cost of improvements, alterations, additions and permanent building accessories, and the amount of legal and architectural fees, as well as digging and leveling costs.

c. Machinery and Equipment: This account includes all assets, such as the plant's machines, and mechanical tools, store equipment and equipment for selling milk.

d. Office Equipment: This account includes all office equipment, such as desks, filing cabinets, photocopying machines, etc.

e. Vehicles for Milk Pickup: This account includes the cost of such vehicles and tanks used for pickup of raw milk from dairy farmers.

f. Vehicles for Sales: This account includes the cost of all vehicles used for sales.

g. Other Vehicles: Recorded in this account are any other such vehicles as

cannot be categorized as a vehicle for pickup of raw milk or sales.

h. Freezers for Customers: Freezers supplied to customers are recorded in this account.

i. Plant Improvements: This account includes capitalized expenses for plant improvements.

j. Water Treatment Plant: This account includes assets relating to the water treatment plant.

k. Construction in Progress: Recorded in this account are the expenses incurred for uncompleted construction work.

l. Accumulated Depreciation and Amortization: This account will include all accumulated depreciation and amortization for all property, plant and equipment in the processing of fluid milk. The method used to depreciate and amortize assets must by the straight line method. Under this method, the cost of the asset is depreciated or amortized in equal proportion through the estimated useful life of the asset. The cost to be depreciated or amortized must be net from any residual value that the asset is estimated to have at the end of its useful life.

6. Other Assets and Deferred Charges: This account shall include all other current and accrued assets adequately designed and supported to demonstrate the nature of each asset included, as well as the deferred charges.

   a. Deferred Charges - Intangible: Deferred charges are expenses that were already incurred, but were postponed for the future. The deferment is made due to the anticipated future benefit or due to the fact that the charge constitutes an appropriate allocation of costs to future operations.

   b. Others: Any other asset that cannot be classified under the existing accounts.

B.4. Liability Accounts for Fluid Milk Businesses

1. Loans Payable: This account shall include the nominal value of all promissory notes, bank overdrafts, banker's acceptances or other similar evidences of debt, payable on demand or within a time not to exceed one year from the date of their issuance.

2. Accounts Payable: Accounts payables are those liabilities that are recurring business obligations of the regulated company. The liability is incurred at the moment when title to the assets is passed or service is provided. Attention must be paid to assets in transit when a period comes to an end. This account shall include all amounts payable of milk processors within one year, for which there are no available funds in other accounts. Accounts payable consist of the following sub-accounts:

   a. Dairy Farmers: This account includes all obligations toward milk producers.

   b. Other Providers: This account includes all other obligations toward providers (excluding dairy farmers).

   c. Dairy Farmer Deduction: The sum of the dairy farmer deduction shall be allocated entirely to the fresh milk business or UHT milk business.

   d. Dividends: Declared dividends payable constitute a liability. If the intention is to pay within the current period, the dividend payable is classified as a current liability. Dividends that have not been declared or dividends from preferred stock in arrears shall not be recorded as liabilities. Dividends shall be accredited to this account when they become a liability. All sums from dividends which have been declared but are unpaid, shall form a part of this account.

   e. Affiliated Companies: This account shall include sums owed to associated companies regarding promissory notes, drafts, banker's acceptances or other similar evidences of debt, and accounts payable on demand or payable within one year from the date of issuance or creation.

   f. Other accounts payable.

3. Accrued Expenses Payable: Liabilities which have not been recorded upon concluding the accounting period shall be recorded as accrued expenses payable.

4. Long-Term Loans Payable: This account shall include the nominal value of all promissory notes, bonds or other similar evidence of debt, payable within a period exceeding one year from the date of its issuance.

B.5. Net Worth Accounts of Fluid Milk Businesses

The Net Worth ("Net Worth = Assets – Liabilities") of fresh milk processors is the

difference between the value of assets and liabilities, which have been allocated, directly or indirectly, to the fresh milk business. By using the same procedure, the Net Worth of UHT milk processors is the difference between the value of the assets and liabilities that have been allocated directly or indirectly to the UHT milk business.

1. Shares of Stock: The stock account consists of common stock and preferred stock. This account reflects the par value or the indicated value of the non-par value stock if said shares have an indicated value, and, if not, the cash value of the benefit received for said non-par stock shares, for every kind of stock issued, including the par value or indicated value of each share of stock.

2. Additional Capital Paid: This account represents the additional capital paid by the shareholders, and therefore, includes the total amount received over and above the par value for the preferred stock and common stock issued.

3. Retained Earnings: The retained earnings by milk processors are categorized as the proportion of the interest of the titleholders in the company assets that is not represented by their paid or contributed capital. Retained earnings represent the ownership interest in the net incremental assets resulting from operations. This account shall include the following two sub-accounts:

   a. Earnings and Losses: Reflect net accrued earnings in prior years and retained in the business.

B.6. Reasonable Profit Margin for Milk Processors

The Regulation of fresh milk and UHT milk prices by ORIL must provide a reasonable profit margin for milk processors. The amount of the after-tax profit margin shall be calculated by applying a reasonable profit margin to the capital base. Then, the amount of reasonable after-tax profit margin shall be converted into a pre-tax margin by dividing it by a coefficient equal to (1-t), where "t" represents the tax rate applicable to the milk business. The amount of pre-tax profit margin will be translated into a per quart profit margin, by dividing the dollar amount of profit margin into the number of quarts of milk sold or projected to be sold in the period under analysis. The procedure for calculating the various components required to calculate the reasonable profit margin for processors is the following:

1. **Capital Base (NW)**:

   a. **Concept**

The reasonable profit margin for processors is based on the **net worth**, which is

equal to the assets less liabilities of the fresh or UHT milk business.

b. **Estimate of Capital Base through the Implementation of this Regulation**

The initial equity for the fresh milk processing plants was calculated for the date before the Implementation of this Regulation. Suiza Dairy equity as of November 6, 2013 is $105,788,360 and Vaquería Tres Monjitas equity as of November 6, 2013 is $46,860,830. The combined equity for the purposes of calculating the allowed profit is $152,649,190. The allowed profit is obtained by multiplying the return on equity, which is defined below, times the combined equity.

The preliminary amortization of the Pre-Tax Regulatory Accrual was included until November 6, 2013 in a lump contribution of five (5) cents per quart (including other concepts) which was deducted from the price of the milk and which, as of the effective date of the New Price Order in compliance with the Preliminary Injunction, will no longer be 5 cents and shall be distributed in the following manner:

a) Contribution to ORIL's Auditing Program and Regulatory Activities - $0.005
b) Regulatory Accrual Payment Reserve – as determined annually

2. **Computation of the Reasonable After- Tax Profit Rate**

a. **Conceptual Procedure for Calculating the Reasonable Rate of Return**

The calculation of the reasonable rate of profit, after payment of the income tax, for fluid milk processing plants shall be done on an annual basis as follows: First, the reasonable rate of return shall be calculated with the Capital Asset Pricing Model (CAPM) plus the premium risk for the smaller companies group (20th percentile) which market their stock on the New York capital markets, "Micro-Cap (Small) Firm Risk Premium". Then, the CAPM formula, including a Micro-Cap Risk Premium, shall be subject to an additional adjustment for the regulatory premium that fluid milk processors have as a result of being regulated companies and conducting businesses in their industry. Therefore, the formula for establishing the rate of return for fluid milk processors shall be the following, which is consistent with the CAPM formula described in Docket 2289:

$$R_{AT} = R_f + \beta \bullet (R_m - R_f) + R_{MC} + R_{RP}$$

R_{AT} = Rate of reasonable return on the capital base (net worth), after tax, which

should be obtained by processors in the fluid milk business in Puerto Rico.

R_{PT} = Pre-tax rate of reasonable return on the capital base (net worth), which should be obtained by processors in the fluid milk business in Puerto Rico. $R_{PT} = R_{AT} / (1-t)$

R_f = Risk-free rate of interest estimated on the basis of bonds issued by the United States Federal Government. (Arithmetic mean of Long-Term Government Bonds Income since 1926, Ibbotson SBBI Valuation Yearbook). For example, if the parties are calculating regulated prices for the year 2011, they should use a risk-free rate value of 5.2%, which is found on page 23 of the *2012 Ibbotson SBBI Valuation Yearbook*, Table 2-1. In accordance with page 97 of Docket 2289, the risk-free rate used in the first term of the CAPM formula shall be the same as that used in the Equity Risk Premium (R_m - R_f).

β = Coefficient that represents the systematic risk of investments in the dairy products sector (SIC Code 202) in the United States. The beta shall be updated yearly.

The beta should be calculated as the median of the **positive unlevered betas within a surrogate set**. The surrogate set comprises firms publically traded on the U.S. stock exchange with more than 75% of their sales in the SIC Code 202 dairy manufacturing code, the so-called "pure play" companies. The composition of the surrogate set should be based on the "pure play" companies that were selected by Morningstar-Ibbotson, excluding companies whose sales represent more than 75% of the total sales for SIC Code 202 (Dean Foods is dropped in each one of those years because its sales exceed the 75% threshold). For example, the median beta, calculated by the above described procedure, for the year 2012 is 0.45.

R_m = Rate of return for a broad portfolio of shares of stock that are marketed in the capital markets of the United States, estimated by the return of the S&P 500 (Arithmetic mean of total returns of Large Company Stocks since 1926, Ibbotson SBBI Valuation Yearbook). Following the example presented in the definition of the risk-free rate, the RM value of 11.8% is found on page 23 of the *2012 Ibbotson SBBI Valuation Yearbook*, Table 2-1, based on data from 1926-2011.

R_{MC}= Additional risk for smaller businesses (20th percentile) that market their stock on the capital markets of the United States (NYSE/AMEX/NASDAQ), as calculated by Ibbotson Associates (Micro-Caps – Deciles 9 and 10). For example, the RMC value, based on data from 1926-2011 (3.89%) is found on page 89 of *2012 Ibbotson SBBI Valuation Yearbook*, Table 7-5.

R_{RP}= Additional investment-specific regulatory premium faced by processors operating their businesses in a regulated environment. The method used establishes a bond spread methodology considering the yield of non-insured and non-guaranteed bonds of Puerto Rico's public corporations that operate like private firms and the yield of the Bond Buyer's Indexes (BBI). The Puerto Rico Aqueduct and Sewer Authority (PRASA) and the Puerto Rico Electric Power Authority (PREPA) are the two public corporations that best fit the concept of public corporations that operate like private firms in Puerto Rico. These two companies are utilities which require large investments in infrastructure. Processing milk plants in Puerto Rico are also regulated companies that require large investments in infrastructure. The method, as described in Appendix 1, only applies for regulated companies that require large investments in infrastructure.

C) **Fresh Milk Retailers**

This section defines the regulatory accounts of expenses incurred by retailers, the sector in charge of the final sale of fresh milk. There are numerous points of sale distributed throughout the island with a variety of cost structures. The retailers' information shall be compiled through sampling. The costs shall be distributed according to the ratio of milk sales to total sales. The recognized costs shall be adjusted to deduct any contributions from processing plants or independent agencies that have the effect of reducing the operating cost of retailers.

The following are the regulatory accounts that shall be recognized:

1. Salaries and Wages: Refer to the remuneration that retailers pay to their employees solely and specifically in relation to the duties they perform in the sale of milk. If these employees carry out other work related to the sale of products other than milk, the portion of the salary and wages corresponding to those other activities shall be deducted from the total of that expense. The percentage of the expenses in salaries that will be recognized shall be in keeping with the percentage of the sales volume of milk in relation to the rest of the products. Any contribution of the processing plants or independent agents to pay the personnel to perform tasks related to the supplying and presenting of the product in the refrigerators shall be deducted.

2. Fringe Benefits: Refer to additional remunerations granted by retailers to their employees, in addition to salary, such as contributions to a private medical insurance plan or other similar benefits. This expense shall be distributed in a manner similar to the distribution of salaries and wages.

3. Payroll Taxes: Refer to the payments or contributions that retailers must make with regard to the salaries and wages paid to their employees, as provided by law. These payroll taxes will be adjusted proportionally to the percentage of time invested by the employees in the sale of products other than milk. This expense shall be distributed in a manner similar to the distribution of salaries and wages.

4. Taxes and Licenses: Refer to the payments of contributions and duties imposed by law on points of sale, after adjusting and excluding the proportional part that must be adjudicated to the sale of other products.

5. Building Expenses: Refer to the expenses incurred in the facilities of the points of sale, and shall be distributed in the proportion related to the milk business.

6. Maintenance of Equipment and Repairs: Refer to the expense incurred in repairs necessary to maintain the equipment of the point of sale in good conditions and at full operating capacity. Any contribution made by the processing plants for the maintenance of said equipment shall be deducted. The depreciation of the milk refrigeration equipment belonging to the point of sale shall also be recognized as a regulatory expense in this item.

7. Supplies: Refer to the supplies used for cleaning the point of sale and the offices. This expense item shall be limited to the portion of the supplies that are used to sell fresh milk, excluding the cost of supplies used to sell other products.

8. Electric Power: Refers to the expense incurred by the point of sale in electric power, as billed by the Electric Power Authority, the only supplier of that power in Puerto Rico. This expense, as with all others, shall be adjusted to the power used exclusively for the sale of fresh milk. The power used in the operation to sell other products shall be separated from same. The amount that will be recognized shall be determined according to the sales volume.

9. Interest: Refers to the expense or cost of the financing obtained by retailers, whose usefulness is directly related to the sale of milk. The amount that will be recognized shall be determined according to the sales volume.

10. Water: Refers to the portion of the cost of water consumption supplied by the Aqueduct and Sewer Authority to points of sale that is directly related to the sale of fresh milk. The water used for the operation of distributing other products shall be separated from same. The amount that will be recognized shall be determined according to the sales volume.

11. Communications: Refer to the expense incurred for telephone services and other

means of communication that are necessary and convenient for the sale of milk. The amount that will be recognized shall be determined according to the sales volume.

12. Professional Services: Refer to the expense incurred by retailers when they recruit and hire independent professionals to provide specific specialized services that their managerial personnel do not provide. This expense must be necessary and indispensable and it must also be directly related to the business of selling milk, not other products. The amount that will be recognized shall be determined according to the sales volume.

13. Insurance Policies: Refer to the expense incurred in insurance premiums contracted by retailers that falls within the margins of reasonability of companies similar to these. The corresponding adjustment must be made insofar as the insurance policies include assets, machinery or equipment that is also used to sell other products. The amount that will be recognized shall be determined according to the sales volume.

14. Other Expenses: All expenses incurred prudently and which are known and necessary and have not been defined in the previous accounts shall be entered in this account. If the expense must be distributed between the product that is regulated by this order and the products that are not, it shall then be recognized according to the percentage of sales.

SECTION 7. Establishment of the Regulated Prices of Milk:

1. **Introduction:**

In compliance with Public Law No. 34 of June 11, 1957, as amended (5 LPRA §1092, et seq.), ORIL's Administrator shall convene a public hearing every year in the month of August to analyze the financial condition of the various participants in the Milk Industry, in order to revise the current Price Order to meet the objective of providing an adequate and reasonable rate of return on the capital base of each participant. Based on the information provided by participants in the milk industry during the public hearing, and any other pertinent information collected by ORIL, the Administrator shall issue a new Price Order, not later than September 30, establishing the regulated prices of milk at all levels of the production, manufacturing, and distribution of the Milk Industry, including an Executive Report supporting the decisions of the Administrator.

As a result of applying the methodologies described above in this Regulation, the regulated price of a product with a higher production cost than another product cannot be below the regulated price of the other product. Alternatively, the regulated price of

that product with a lower production cost must be below the regulated price of the product with a greater production cost.

2. **The Price of Producers**:

The price of producers is the price that all the processors, including the balance plant, pay for milk, minus the deductions for the industry programs and the transportation of raw milk. The price of producers must be established in a way that will guarantee an adequate production of milk in the long run taking into consideration the level of the prices of fresh milk and UHT milk for consumers and the resulting demand for both products.

ORIL will use an adjustment procedure to establish the price of producers. That price, the prices of consumables and the average cost of production of dairy farms are data known for a recent period of time. The volume of milk that producers freely decide to produce at a specific price and under specific cost conditions is known. The level of the demand for fresh milk and UHT milk at their regulated retail prices during that period of time is also known. With that information, we know whether the production of raw milk is low, adequate or excessive.

In the future, ORIL will obtain the projections of the prices of components for the following year from other agencies, the futures market and independent third party sources. ORIL will estimate the percent change in the weighted average cost of production for the new year using the price projections of consumables for the following year and the total weighted average cost of production for the most recent period. ORIL will determine the change in the price of producers depending on the percent change in the cost of production based on its determination about whether the production of milk during the recent period was low, adequate or excessive. In addition to the short term adjustments in the cost of production, ORIL shall consider any longer term change in the volume of production that may occur during the year. These changes include but are not limited to the increase or decrease in the number of milking cows in Puerto Rico. To establish the price for producers, ORIL must consider the changes in the demand for fresh milk and UHT milk that occur due to the changes in the prices of milk and other economic factors.

3. **The Margin and Prices for Milk Processors**:

In the Public Hearing to be held in August of every year to revise the regulated prices of milk, ORIL shall consider the following information regarding the operation of milk processors:

a. The regulatory financial statements of the calendar year prior to the time

of the public hearing to be held in August, that were audited by ORIL. For example, in August 2014, ORIL shall consider the structure of income and expenses of milk processors during calendar year 2013, including the amount in dollars and cents per quart of milk sold.

b. The preliminary regulatory financial statement of the first semester of the year in which the public hearing is to be held in August. Thus, the preliminary regulatory financial statement of the period covering the months of January to June 2014, shall be reviewed and consider by ORIL in the hearing to held in August 2014.

c. ORIL shall also consider the information and documents submitted by milk processors in the August public hearing, regarding changes in their cost of production during the period after the calendar year prior to the time of the public hearing, such as changes in the cost of gasoline and diesel, electricity, resin, and salaries and fringes revised in the most recent Collective Labor Agreement.

d. ORIL shall also consider the information submitted by milk processors regarding reasonable expected changes in expenses, and a forecasted volume of sales, for the period starting with the issue of a new Price Order in the month of September of every year and ending in the month of September of next year. For example, when ORIL will issue a new Price Order in September 2014, the Administrator should consider that the Order will be in force until September 2014, except in the case that the Administrator may be forced to issue a new Price Order before September 2014, due to extraordinary circumstances affecting the milk industry.

ORIL shall include an estimate of a reasonable return on the shareholders' net worth (equity capital) as submitted by the processing plants based on the methodology of Section B.6 above which, when added to the costs of production, should produce the price per quart for the sale to retailers. When calculating the regulated margin for milk processing plants, expense accounts 1 [Raw Milk], 33 [Exclusivities] and 34 [Transportation Cost Recovery] should not be included as a cost. The fresh milk that the processing plants sell to their agents will have a discount in its price to reflect the costs of the distribution services provided by the agents. ORIL may recognize discounts of up to 6.5 cents per quart for agents, based on the recent information about them. To grant higher discounts, the discounts must be justified by the processing plant or the agents. ORIL may allow different margins and/or different prices for different products of fluid milk, including different sizes and types of containers and different nutritional compositions, including different fat contents, fortified products and flavors.

ORIL could not impose any cost or charge on the fluid milk processing plants to subsidize, pay, credit (or any synonym) to give one of the fluid milk processing plants funds for its operation. Neither could ORIL create a mechanism that will allow one fluid milk processing plant to obtain a competitive advantage for its products and being financed by the other fluid milk processing plants.

4. **The Margin of Fresh Milk Retailers and Their Prices**:

ORIL shall require information from retailers to determine the average cost per quart in the sale of fresh milk to consumers during the most recent calendar year. This total average cost per quart shall include a reasonable return on the capital invested in the sale of milk. The invested capital and its return, calculated per quart, must reflect the recurrent and ongoing sales of milk compared to the sales of other products in the retailers' business establishments.

ORIL shall then estimate how the changes in the prices of consumables will affect the total average cost per quart during the following year and shall add that change to the current margin of retailers. The retail price of the fresh milk products must be equivalent to the wholesale price plus the margin recognized to retailers.

SECTION 8. Ongoing Audits and Regulatory Accounting:

With the approval and promulgation of the regulations herein, this administrative agency shall design and establish a program of ongoing audits of the operations of all the sectors that make up the milk industry in Puerto Rico.

To do this, a program shall be designed within no more than ninety (90) days, and the officials who are necessary for its effective implementation shall be hired. The costs and expenses generated by this program shall be defrayed by a portion of the price of fluid milk at the consumer level. The amount that will be earmarked for the fund shall be determined by the Administrator. The Milk Industry Development Fund shall create a special account for these funds, and shall manage and keep same in compliance with the orders it receives from the Administrator.

In the auditing process, ORIL's auditors shall use the regulatory accounting system established in this Regulation. The regulated parties will be under the obligation to supply the required information in a uniform format the categories of the regulatory accounting system established in this regulation, that allow for the quick and accurate analysis of the data they supply regarding their respective operations.

The participation and cooperation of all the components of the milk industry in the ongoing audit program and the regulatory accounting system they shall use to

report the required data shall be compulsory. Therefore, failing to comply with the obligations imposed by this program and with the obligation to report the required data, as defined in the regulatory accounting, shall constitute regulatory violations subject to the penalties established in the corresponding legislation.

SECTION 9. Priority Criteria for the Use of the Raw Milk Supply:

In order of priority, the raw milk produced in Puerto Rico shall first be used to process fresh milk. After exhausting the supply of the fresh milk processing plants, the surplus shall be used to process other products by the fresh milk processing plants and the balance plant. The order of priority for the additional products processed with the surplus milk shall be determined based on their economic return, starting with the products with the greatest return and continuing with the others in descending order.

SECTION 10. General Provisions:

1. The provisions of these regulations are independent, and any determination of unconstitutionality or nullity of any of the rules herein shall in no way affect the remaining rules, which shall continue in full force.

2. Any of these rules may be amended or repealed and additional rules may be adopted following the corresponding legal procedure.

3. These regulations shall come into effect 30 days after they are filed with the Puerto Rico Department of State and after they are published and announced in compliance with all the requirements provided and required by Public Law No. 170 of August 12, 1988, as amended.

4. Different or contradictory provisions of previous regulations that conflict with the provisions of the regulations herein are hereby repealed.

5. This Regulation will be interpreted in a liberal way in favor of the authority of the Administrator to regulate the milk industry and its by-products, to the effect of enforcing the policy of Law 34 of of 1957, as amended. To that effect, the Administrator could formulate and adopt the necessary measures and plans to face the variations and changing conditions of the industry, all of this to protect the general interest and the public policy.

6. The provisions of this Regulation must be interpreted altogether with other norms, regulations, policies and procedures issued by the Office of the Milk

Industry. The words and phrases used should be interpreted in coordination with the laws and regulations of the Government of Puerto Rico and according to the common use and meaning, except that said interpretation or meaning is considered absurd. The words used in present tense should include the future tense; the words used in male gender should include female or neutral gender, except in the cases in which such interpretation seems absurd. The singular number should include the plural number and viceversa.

7. The Spanish version of this Regulation prevails over the English version.

SECTION 11. Coexistent or Contradictory Clauses:

In case that any requirement established in any of the provisions of this Regulation is more restrictive than any requirement included in any other part of the same or any other law, regulation, norm, or in any way limits the authority or jurisdiction of the government, the more restrictive requirement will prevail.

SECTION 12. Exception Clause:

If any article, clause, sub-clause, paragraph, sub paragraph, o any part of this Regulation is declared unconstitutional or null by any Court with Jurisdiction, the Judgment as to that effect will not affect, prejudice or invalidate the rest of the provisions of this Regulation, and the effects of said Judgment will be limited to said article, clause, sub clause, paragraph, sub paragraph or part of this Regulation that was declared unconstitutional or null.

SECTION 13. Validity:

This Regulation will be valid thirty (30) days after the presentation on the State Department in compliance with the dispositions of Law No. 170 of August 12, 1998, as amended, denominated "Uniform Law of Administrative Proceedings of the Commonwealth of Puerto Rico".

SECTION 14. Approval:

On San Juan, Puerto Rico, on 29th of October 2013.

Por Myrna Correa

AGRO. JOSÉ A. PANTOJA LÓPEZ
ADMINISTRADOR

APPROVED BY:

DRA. MYRNA COMAS PAGÁN
SECRETARIA

Filed at the State Department on ____________ of 2013.

APPENDIX 1: Methodology to Calculate the Regulatory Premium

This Appendix explains the method to calculate the regulatory premium. The premium for a regulated processor operating in the fluid milk business should be calculated by relying on the absolute or relative differential between the interest rates on the bonds of Puerto Rican public corporations that operate like private firms and are regulated utilities (PRASA and PREPA) and the Bond Buyer's Indexes (BBI) of the same maturity. The BBI's indexes comprise the yield of weekly 20-Bond GO Index, comprising bonds that mature in 20 years, and the 25-Revenues Bond Index, combining bonds that mature in 30 years. Following the literature regarding measurement of the equity risk premium, the relative bond spread methodology between the yields of PRASA and PREPA and the Bond Buyer's Indexes (BBI) is the one that should be used to adjust the CAPM in Puerto Rico, thus capturing the additional premium for equity investments in the fresh milk processing business. This methodology accepts the fundamental principle that adjustment to the cost of equity to recognize the non-diversifiable investment-specific or unsystematic premium faced by processors operating in the fluid milk business in Puerto Rico must be greater than the percentage points of the absolute bond-spread between the average bond yields of PRASA-PREPA and the average yield of the Bond Buyer's Indexes.

In any particular period, the formula to determine the CAPM shall be the following:

$$R_{AT} = \left(\frac{PRASAPREPA}{BBI}\right) \bullet CAPM^{US202}$$

$$R_{RP} = \left[\left(\frac{PRASAPREPA}{BBI}\right) \bullet CAPM^{US202}\right] - CAPM^{US202}$$

where:

$CAPM^{US\ 202}$ = Representative value of ROE of the U.S. Dairy Products Sector (SIC 202), based on U.S. companies selling their stock in U.S. capital markets, which is $R_f + \beta \bullet (R_m - R_f) + R_{MC}$.

PRASAPREPA = Arithmetic average of the yields of all bonds issued by PRASA and PREPA, non-insured and non-guaranteed by the Commonwealth

Government, with 20-year and 30-year maturities, during a specific period of time.

BBI = Arithmetic average of selected BBI's bond yields, matching maturities and months of bond issues of PRASA and PREPA.

For each year, all bond issues of PREPA and PRASA should be identified and taken into account for the calculation of R_{RP}. Also, for each bond issue of PREPA and PRASA issuance, the corresponding Bond Buyer's Index (BBI) average yield shall be identified, matching maturity, for the necessary comparisons for the R_{RP} formula. The specific month of the bond issue shall be used in determining what month of BBI averages should be used. The average yield of a Puerto Rico bond, using PREPA and PRASA, is then divided for each year by the BBI average yield, obtaining an estimate of the relative bond spread (PRASAPREPA/BBI).

If there are no bond issues of either PREPA or PRASA in the relevant year, the previous year's R_{RP} should be adopted.

When the rate of return is calculated for establishing the regulated margin to be added in the price of fluid milk, the date of the variables should be the most recent year available. For example, the rate of return to be calculated in August 2014, to support a new Price Order to be issued by the Administrator, should be based on the information specified in Section 7.3 of this Regulation, as well as the estimate of the reasonable allowable rate of return for 2013.